

# Participating Investments — The Common Trust Fund Device

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The term *participating investments* means investments in which several investors participate as owners in common. Applied to trusts, it means investments in which two or more trusts participate.

## TYPES OF PARTICIPATING INVESTMENTS

There are several types of investments in which two or more trusts may participate as owners in common.

1. *Mortgage pool.* Two or more mortgages are pooled as a single investment against which mortgage participations are issued to and owned by participating trusts.

2. *Split mortgages.* A single mortgage is owned by several participating trusts.

3. *Regulated investment company.* The Federal Revenue Code provides for regulated companies which are a pool of investments owned by participating trusts. Equitable Fund A of Equitable Trust Company, Wilmington, Delaware, is a regulated investment company rather than a common trust fund.

4. *Common trust fund.* A common trust fund is a fund composed of moneys contributed by estates, trusts, and guardianships under administration by the same bank or trust company and administered according to regulations promulgated by the Board of Governors of the Federal Reserve System. The term *common trust fund* is highly technical and never should be employed except in its technical sense.

With reference to different types of common trust funds several terms are used with which the reader of this article should be familiar. A *contract* fund is one in which estates, trusts, and guardianships can participate only if the executor, trustee, or guardian is expressly authorized so to participate. A *discretionary* fund is one in which the trustee of the fund is authorized to exercise its own discretion as to investments. It might as well be called the *prudent-man* fund, for the trustee is governed by the prudent-man rule. A *legal* fund is one in which the investments must be legal under the law of the jurisdiction that controls the investment of the fund. An *all-stock* fund is one in which all the investments are shares of stock. An *all-bond* fund is one in which all the investments are bonds.

The subtitle of this article, *The Common Trust Fund Device*, restricts discussion to common trust funds in the technical sense. It

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does not permit discussion of mortgage pools, split mortgages, or regulated investment companies.

#### ORIGIN OF COMMON TRUST FUNDS

The basic idea of the common trust fund device is well over a century old. It dates back to the 1820's. The first type of trust business carried on by corporations, of which we have any record, is essentially participating-investment service. People with funds to invest would take them to one of these corporations. The corporation would pool the funds of its customers and invest them as a single fund. Each participant owned a fractional interest in the entire fund.<sup>1</sup>

After corporations in the 1830's went into the trust business as we understand it—executorships, administratorships, trusteeships, guardianships—we hear little further of participating-investment service until about 1928—nearly a century later. At that time three trust companies—Brooklyn Trust Company, Brooklyn; Farmers Loan and Trust Company (now City Bank Farmers Trust Company), New York City; and Equitable Trust Company, Wilmington, Delaware—began to offer a somewhat different type of participating-investment service which, however, retained the basic idea. The Brooklyn Trust Company established what it called its Composite Trust; Farmers Loan and Trust Company, its Uniform Trust; and Equitable Trust Company, its Funds A and B. All these were contract funds as above defined.

This revived and modernized participating-investment service was just getting under way when in 1936 the courts held that the Composite Trust of Brooklyn Trust Company was liable for federal income tax as an association.<sup>2</sup>

The practical effect of this decision was that the income of the participating-investment fund was subject to two federal income taxes—one levied against the income of the fund itself as an association and the other against the income of the participating trusts after it had been paid over to them. This was a clear case of double taxation and, more than that, it was levied against the beneficiaries of small trusts who were, in the main, least able to bear the tax burden.

The Congress, as soon as it was apprised of the situation, was sympathetic towards relieving the income of such funds from taxation as an association. Accordingly, in the Federal Revenue Act of 1936<sup>3</sup> the Congress defined the term *common trust fund* as a fund

<sup>1</sup> SMITH, JAMES G., *TRUST COMPANIES IN THE UNITED STATES* 238-246 (1928).

<sup>2</sup> *Brooklyn Trust Co. v. Commissioner of Internal Revenue*, 80 F. (2d) 865 (C. C. A. 2d, 1936), *cert. denied*, 298 U. S. 659 (1936).

<sup>3</sup> § 169

maintained by a bank (including a trust company) exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian and in conformity with rules and regulations prevailing from time to time of the Board of Governors of the Federal Reserve System pertaining to the collective investment of trust funds by national banks. Having so defined a common trust fund, the Congress went on to say that such a fund so maintained would not be subject to federal income taxation as an association.

However, Section 169 of the Revenue Act of 1936 limited the tax relief of common trust funds so defined in two ways. First, it required that the fund be used exclusively by the bank for its own accounts. The accounts of one bank could not purchase participations in the common trust fund of another bank. Second, the fund could not be used for agencies, but only for estates, trusts and guardianships.

The next step was for the Board of Governors of the Federal Reserve System to promulgate rules and regulations pertaining to the collective investment of trust funds by national banks. Accordingly, as of December 31, 1937, the Board promulgated the requisite rules and regulations as Section 17 of Regulation F—Trust Powers of National Banks.

Regulation F, in turn, placed still another restriction upon the income-tax relief of common trust funds by authorizing the establishment and maintenance of such funds in accordance with its rules and regulations only "whenever the laws of the state in which the national bank is located authorize or permit such investment by state banks, trust companies, or other corporations which compete with national banks."<sup>4</sup>

This provision of Section 17 of Regulation F sent banks and trust companies to the statutes and judicial decisions of their state to see if the law of the state authorized or permitted the collective investment of trust funds by state banks and trust companies. They found, as might have been expected, a dearth of law on the subject. Vermont was the one state that by statute had authorized the collective investment of trust funds,<sup>5</sup> and the Proctor Trust Company of Proctor, Vermont, had been conducting a commingled fund, although not technically a common trust fund, since 1933.

Steps were taken promptly to obtain the state legislation necessary to meet the requirement of Section 17 of Regulation F. First, the Commissioners on Uniform State Laws proposed a brief Uniform Common Trust Fund Act. Although this Act has been followed to the letter by very few states, it has, none the less, served as the

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<sup>4</sup> Regulation F 17(a).

<sup>5</sup> Vt. STATS. 1947 § 8873.

basis of a great deal of recent state legislation on common trust funds.

Without classifying the states into those that have adopted the Uniform Act, those that have adopted it with variation, and those that have worked out and adopted their own original common trust fund acts, the following is a list of the states, districts, and territories that have adopted statutes authorizing the establishment and maintenance of common trust funds by state banks and trust companies, the figures in parentheses being the date of adoption of the statute: Alabama (1943),<sup>6</sup> Arizona (1941),<sup>7</sup> Arkansas (1947),<sup>8</sup> California (1947),<sup>9</sup> Colorado (1947),<sup>10</sup> Connecticut (1943),<sup>11</sup> Delaware (1935),<sup>12</sup> District of Columbia (1949),<sup>13</sup> Florida (1941),<sup>14</sup> Georgia (1943),<sup>15</sup> Hawaii (1947),<sup>16</sup> Idaho (1949),<sup>17</sup> Illinois (1943),<sup>18</sup> Indiana (1937),<sup>19</sup> Kansas (1951),<sup>20</sup> Kentucky (1938),<sup>21</sup> Louisiana (1938),<sup>22</sup> Maine (1951),<sup>23</sup> Maryland (1945),<sup>24</sup> Massachusetts (1941),<sup>25</sup> Michigan (1941),<sup>26</sup> Minnesota (1937),<sup>27</sup> Mississippi (1950),<sup>28</sup> New Jersey (1945),<sup>29</sup> New York (1937),<sup>30</sup> North Carolina

<sup>6</sup> ALA. CODE 1940, tit. 58, §§ 88 to 103.

<sup>7</sup> ARIZ. CODE 1939 (Supp. 1945) §§ 51-1101 to 51-1104.

<sup>8</sup> ARK. STATS. 1947 §§ 58-110, 58-111.

<sup>9</sup> CALIF. BANKING CODE § 1564; REVENUE AND TAXATION CODE §§ 18210 to 18216.

<sup>10</sup> COLO. LAWS 1947, c. 325.

<sup>11</sup> CONN. GEN. STAT. 1949 § 5805.

<sup>12</sup> DEL. REV. CODE 1935, c. 117, § 35(e), as amended by LAWS 1947, c. 258.

<sup>13</sup> D.C. LAWS 1949, PUB. LAW 416, c. 767.

<sup>14</sup> FLA. STATS. 1949 §§ 655.29 to 655.34.

<sup>15</sup> GA. CODE 1933 (Supp. 1943) §§ 109-601 to 109-622, as amended by LAWS 1947, No. 96, p. 478.

<sup>16</sup> REV. LAWS. 1945 §§ 8674 to 8683, as inserted by LAWS 1947, p. 361.

<sup>17</sup> IDAHO CODE 1947 §§ 68-701 to 68-703.

<sup>18</sup> ILL. REV. STAT. (State Bar ed. 1949) c. 16½ §§ 57 to 63, as amended by LAWS 1949, p. 340.

<sup>19</sup> IND. STAT. (Burns 1933, Supp. 1947) §§ 18-1204 and 31-501.

<sup>20</sup> KAN. LAWS 1951, §§ 1 and 2, approved March 29, 1951.

<sup>21</sup> KY. REV. STAT. 1946 § 287, 230.

<sup>22</sup> LA. GEN. STAT. (Dart 1939) § 9850.64.

<sup>23</sup> ME. LAWS 1951, c. 358.

<sup>24</sup> MD. ANN. CODE 1939, art. 11, § 62A, art. 81, §§ 3(6), a51½, as amended by LAWS 1945, cc. 251, 252.

<sup>25</sup> MASS G. L. (Ter. ed. 1932) c. 203a, §§ 1 to 11, as amended by LAWS 1945, c. 67, and LAWS 1949, c. 755.

<sup>26</sup> MICH. STATS. ANN. §§ 23.1141 to 23.1155.

<sup>27</sup> MINN. STAT. 1945 § 48.84, as amended by LAWS 1947, c. 234.

<sup>28</sup> MISS. LAWS 1950, H. B. 461, effective June 30, 1950.

<sup>29</sup> N.J. REV. STAT. 17:9A-230 to 17:9A-246.

<sup>30</sup> N.Y. BANKING LAW § 100-c, as amended by LAWS 1950, c. 464.

(1939),<sup>31</sup> Ohio (1943),<sup>32</sup> Oklahoma (1949),<sup>33</sup> Oregon (1951),<sup>34</sup> Pennsylvania (1939),<sup>35</sup> South Dakota (1941),<sup>36</sup> Texas (1947),<sup>37</sup> Utah (1951),<sup>38</sup> Vermont, (1933),<sup>39</sup> Virginia (1944),<sup>40</sup> Washington (1943),<sup>41</sup> West Virginia (1943),<sup>42</sup> and Wisconsin (1943),<sup>43</sup>

For their authority to establish and maintain common trust funds the banks and trust companies of Missouri have relied upon a decision of the Supreme Court of that state.<sup>44</sup>

This makes 39 states (including the District of Columbia and Hawaii) which by statute or judicial decision have authorized the establishment and maintenance of common trust funds, leaving only: Iowa, Montana, Nebraska, Nevada, New Hampshire, New Mexico, North Dakota, Rhode Island, South Carolina, Tennessee, and Wyoming without such authorization. It is interesting to note in passing that in 1950 the Province of Ontario, Canada, adopted a common trust fund enabling act.

The foregoing account of the origin of the common trust fund points up the importance of using the term *common trust fund* in its technical sense only, meaning (1) a fund composed of funds contributed by estates, trusts and guardianships, (2) established, maintained and operated by a bank or trust company for the exclusive use of its own estates, trusts and guardianships, (3) under authority or permission of the law of the state in which the bank or trust company is located, (4) according to rules and regulations promulgated by the Board of Governors of the Federal Reserve System. Each of these four conditions must be satisfied, not for the legality of the fund, but for the relief of the income of the fund from double taxation.

#### LEGALITY OF COMMON TRUST FUNDS

For the legality of the collective investment of trust funds, one

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<sup>31</sup> N.CAR. GEN. STAT. 1943 §§ 36-47 to 36-52.

<sup>32</sup> OHIO GEN. CODE §§ 710-164, 715-722.

<sup>33</sup> OKLA. STATS. ANN., tit. 60, § 162.

<sup>34</sup> ORE. LAWS 1951, c. 79.

<sup>35</sup> PENNA. STAT. ANN. (Purdon) tit. 7, §§ 819-1109 to 819-1109d, as amended by LAWS 1947, No. 427, tit. 15, § 2851-318, as inserted by LAWS 1947, No. 90, tit. 20, § 821.13.

<sup>36</sup> S.D. LAWS 1941, c. 20.

<sup>37</sup> TEX. STATS. (Vernon) art. 7425b-48, as amended by LAWS 1947, c. 209.

<sup>38</sup> UTAH LAWS 1951 §§ 7-4a-16, 7-4a-17.

<sup>39</sup> VT. STATS. 1947 § 8873; called associated trust investment account.

<sup>40</sup> VA. CODE 1950 §§ 6-569 to 6-576.

<sup>41</sup> WASH. REV. STAT. (Remington 1932, Supp. 1943) §§ 3388 to 3388-4.

<sup>42</sup> W. VA. CODE 1949 §§ 4219(1) to 4219(3), as inserted by LAWS 1945, c. 4.

<sup>43</sup> WIS. STAT. 1949 § 223-05(5).

<sup>44</sup> St. Louis Union Trust Company v. Toberman, 235 Mo. App. 559, 140 S.W. 2d 68 (1940).

must look to the common law, the statutes, and the provisions of trust instruments.

#### *At Common Law*

At common law, in the absence of an enabling statute or provision in the trust instrument, the collective investment of trust funds would be of doubtful legality in that it would violate one of the fundamental principles of trust law—namely, that the property of each trust must be kept separate from that of other trusts and separately also from that of the trustee himself.<sup>45</sup>

The state legislature has the power to authorize the collective investment of trust funds and to prescribe the terms and conditions upon which they may be invested collectively. In fact, all of the enabling legislation that has been adopted in recent years in relation to common trust funds has been predicated upon the assumption that the state legislature does have such power.

#### *By Trust Instrument*

Nor is there any more doubt that a settlor may, by the terms of his trust instrument, authorize or even direct his trustee to invest in participating investments. But he cannot, effectively, *direct* his trustee to invest in common trust fund participations because the fund must be under the exclusive control of the bank or trust company and it must, therefore, have full power to exclude any of its trusts from participation in its fund.

The legality of a common trust fund, authorized or permitted by state law and operated under regulations promulgated by the Board of Governors of the Federal Reserve System, seems not to be open to question now, if it ever was.

### REGULATION OF COMMON TRUST FUNDS

As has been stated already, if a trust of participating investments is to be relieved of taxation as an association, it must be operated under rules and regulations promulgated by the Board of Governors of the Federal Reserve System as contained now in Section 17 of Regulation F.

#### *In General*

Section 17 provides for three types of common trust funds and prescribes different regulations for each type. However, there are certain regulations that apply to all three types.

Each bank's common trust fund of whatever type must be for the exclusive use of its own estates, trusts, and guardianships.

The certificate or other evidence of participation in a common trust fund must be non-negotiable and non-assignable. Participations in a common trust fund never get into the hands of the investing public, not even into the hands of the beneficiaries of the

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<sup>45</sup> SCOTT, TRUSTS § 227.9 (1939) and 1951 supplement.

#### *By Statute*

trust. The first common trust funds issued to participating accounts, certificates that looked very much like certificates of stock or bonds. The present practice is not to issue certificates but to rely upon book entries as evidence of the participation of the particular account in the fund.

A bank must not invest its own funds in its common trust fund, nor can it have any interest (except as temporary security) other than as fiduciary in the property of its common trust fund.

*For Investment of Small Amounts*

A bank may establish a common trust fund for the investment of small amounts—not over \$1,200 of the funds of any one estate, trust or guardianship. This fund must observe all the general regulations mentioned above. In addition, participation in the fund must be approved by its trust investment committee. This type of fund is not subject to the regulations of the general investment fund next to be discussed.

*For General Investment*

This is the usual type of common trust fund the regulation of which is the most detailed.

It must be operated under a written plan approved by the board of directors and the legal counsel of the bank. A copy of the plan must be open to inspection at all reasonable hours by any person who is financially interested in the estate, trust or guardianship that is participating in the fund.

The funds of no estate, trust or guardianship shall participate in the fund except upon the approval of the trust investment committee of the bank. The committee must not approve the purchase of a participation in the fund if it contains any investment that it would be unlawful for that account to invest in at the time. A single unlawful investment in the fund freezes it against any further participation unless or until the unlawful investment has been removed.

Before any account can be admitted to the fund for the first time, notice of intention to admit it must be sent to each person to whom an accounting ordinarily would be made, unless the trust instrument itself authorizes investment in common trust funds.

The fund must be audited at least once during each twelve months by auditors answerable only to the board of directors of the bank. The report of the audit shall contain a list of the investments in the fund, the value placed on each investment by the trust investment committee at the time of the audit, the purchases, sales, and other investment changes, and a statement of the investments in default as to either income or principal. A copy of the report must either be mailed to each person entitled to an accounting or he must be notified that the report is available to him for inspection at the

office of the bank. But the bank must not publish nor authorize the publication of the report or the information contained therein. Each copy of the report sent out must carry a statement to the effect that the publication of such copy or of the information contained therein is unauthorized.

The investments in the fund must be evaluated not less than once each three months. No participation in the fund can be admitted or withdrawn except upon the basis of such evaluation.

No estate, trust or guardianship shall own more than 10 per cent of the fund. Not over \$100,000 of any one account can be invested in the fund. Originally this was \$25,000; later, \$50,000; and increased to \$100,000 in February 1951. The fund shall not purchase nor own more than 10 per cent of the stocks, bonds, or other obligations of any one person, firm or corporation, except government bonds. The fund shall not purchase nor own more than 5 per cent of the outstanding shares of any one class of stock of any corporation. The fund must contain at all times at least 40 per cent of cash or readily marketable securities. Distributions can, at the option of the trustee, be made in cash or kind, except that there can be no distribution in cash so long as the fund contains an unlawful investment.

Unlawful investments withdrawn from the fund are set aside in a separate fund to be administered and liquidated for the pro rata benefit of the participants in the fund while it held the unlawful investment.

The fund must be under the exclusive management of the bank. This means that co-trusteeships, for example, cannot participate in the fund unless the co-trustees, other than the bank, relinquish their right to manage or have any part in the management of that portion of the trust that is invested in the common trust fund.

The bank cannot charge any fee for the management of the fund. This means that it must look to the estates, trusts, and guardianships participating in the fund for its usual compensation.

The bank must not permit an account to participate in the fund if it has reason to believe that it was not created for bona fide fiduciary purposes. This would discourage, if not prevent, a person from creating or a bank from accepting a trust if the only purpose was to obtain participation in the fund.

A bank must not advertise or publicize the earnings of the fund or the value of the assets in the fund. The purpose of this is to prevent competition among banks over the showing of their common trust funds.

No mistake by the bank as trustee of the fund made in good faith and in the exercise of due care shall be regarded as a violation of the regulations if the mistake is corrected as soon as possible



after its discovery. This was an especially salutary provision while common trust funds generally were in the experimental stages, and still is salutary for banks establishing these funds.

#### *Mortgage Investment Fund*

There is a provision in the regulations for a common trust fund composed principally of mortgages. This type of fund is not entitled to income tax relief unless such investments are specifically authorized by the statutes of the state in which the fund is administered. According to this, neither a judicial decision nor a general enabling act would suffice.

Many of the regulations relating to this type of fund are similar to those relating to the fund for general investment. The following are regulations that apply distinctively to mortgage investment funds.

All real property securing mortgages in the fund and all real property in the fund must be appraised once every three years by two appraisers at least one of whom shall not have participated in the last preceding appraisal. The appraisers must be appointed by the bank's board of directors, must be familiar with real property values, and must inspect the property and make a certificate to that effect in the report of appraisal.

No account shall purchase a participation in this fund which would result in its owning over \$1,200 or 2 per cent of the fund, whichever would be greater, but in no event over \$10,000.

The fund must not acquire or hold over 10 per cent of the obligations issued or guaranteed by any person, firm, or corporation, except obligations of the United States government.

If the fund does not exceed \$200,000, no mortgage over \$10,000 can be taken into the fund. If it exceeds \$200,000, 5 per cent of the fund or \$50,000, whichever is greater, can be invested in a single mortgage.

Not less than 5 per cent of the principal (not income) of the fund must be kept in cash.

If more than 10 per cent of the investments in the fund are disqualified as investments under a later section of the regulation, no new participations can be admitted to the fund.

The bank must retain a reserve account of not less than 10 per cent of the fund, but not more than 10 per cent of the income of any year nor more than 1 per cent of the average value of the fund shall be used for building up or maintaining the reserve.

The following types of mortgages qualify as investments for the fund: (1) mortgages insured by the Federal Housing Administration, (2) mortgages that national banks may purchase, (3) mortgages amortized on a 20-year basis at 5 per cent a year; provided, in

all cases, that the mortgage qualifies as a legal investment for trust funds under the laws of the state in which the bank is located.

If qualified mortgages are not obtainable, the trust investment committee of the bank can invest temporarily in government bonds and in bonds of the state in which the bank is located, disposing of such bonds and investing in mortgages as soon as they become available.

Although for several years this type of common trust fund has been covered by regulations and, therefore, permissible, up to the present time practically no use of the fund has been made. Banks generally seem to think that the fund for general investment, in which they can carry as high as 60 per cent of the fund in mortgages, will serve their purpose. The percentage, 60 per cent, is allowed under the regulation that not less than 40 per cent of the fund must be held in cash or invested in readily marketable securities, and mortgages would not be classified as readily marketable securities.

#### COMMON TRUST FUNDS IN OPERATION

Twenty-three states and the District of Columbia had common trust funds in operation on October 1, 1951.<sup>46</sup> They are common trust funds in the technical sense. They do not include other com-

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<sup>46</sup> *Alabama*—First National Bank of Birmingham, *D*, 1947; First National Bank of Montgomery, *D*, 1946.

*California*—Title Insurance and Trust Company, Los Angeles, *D*, 1951; First National Trust and Savings Bank, San Diego, *D*, 1942; Bank of America N. T. & S. A., *D*, 1947.

*Colorado*—United States National Bank of Denver, *D*, 1949.

*Connecticut*—Bridgeport-City Trust Company, Bridgeport, *D*, 1947; First National Bank & Trust Company, Bridgeport, Fund A, *D*, 1943, Fund B, *D*, 1945; Hartford-Connecticut Trust Company, Hartford, *D*, 1948; Phoenix State Bank & Trust Company, Hartford, *D*, 1946; First National Bank & Trust Company, New Haven, *D*, 1947; Union & New Haven Trust Company, New Haven, *D*, 1950; Colonial Trust Company, Waterbury, *D*, 1948.

*Delaware*—Equitable Trust Company, Wilmington, Fund B, *L*, 1930, Fund C, *L*, 1934; Security Trust Company, Wilmington, *D*, 1943; Wilmington Trust Company, Wilmington, *D*, 1941.

*District of Columbia*—American Security & Trust Company, Washington, *D*, 1950; Washington Loan & Trust Company, Washington, *L*, 1950.

*Georgia*—Citizens & Southern National Bank, Atlanta, *D*, 1949; Trust Company of Georgia, Atlanta, *D*, 1944.

*Illinois*—City National Bank & Trust Company, Chicago, *D*, 1947; Continental Illinois National Bank & Trust Company of Chicago, *D*, 1949.

*Indiana*—Old National Bank, Evansville, *D*, 1950; Fletcher Trust Company, Indianapolis, *D*, 1949.

*Kentucky*—Kentucky Trust Company, Louisville, *D*, 1950.

*Maryland*—Equitable Trust Company, Baltimore, *D*, 1945; Fidelity Trust Company, Baltimore, *D*, 1951; Safe Deposit and Trust Company, Baltimore, *D*, 1945; Union Trust Company of Maryland, Baltimore, *D*, 1950.

*Massachusetts*—Boston Safe Deposit & Trust Company, *D*, 1945; Day Trust Company, Boston, *D*, 1950; First National Bank of Boston, *D*, 1947; National

mingled funds—such as Equitable Trusts Company's Fund A—which do not qualify under Regulation F, Section 17, as common

Shawmut Bank of Boston, *D*, 1948; New England Trust Company, Boston, *D*, 1948; Old Colony Trust Company, Boston, *D*, 1945; State Street Trust Company, Boston, *D*, 1947; Hadley Falls Trust Company, Holyoke, *D*, 1950; Union Trust Company of Springfield, *D*, 1951; Worcester County Trust Company, Worcester, *D*, 1948.

*Minnesota*—First First Company of St. Paul, *L*, 1937; Northwestern National Bank of Minneapolis, *D*, 1945.

*Missouri*—City National Bank & Trust Company, Kansas City, *D*, 1951; Commerce Trust Company, Kansas City, *D*, 1950; Mississippi Valley Trust Company, (recently merged with Mercantile Commerce Trust Company into Mercantile Trust Company) St. Louis, *D*, 1942; St. Louis Union Trust Company, St. Louis, Fund A, *D*, 1941, Fund B, *D*, 1942; Security National Savings & Trust Company, St. Louis, *D*, 1940.

*New Jersey*—First Camden National Bank & Trust Company, Camden, *D*, 1948, *L*, 1948; Burlington County Trust Company, Moorestown, *L*, 1945; Princeton Bank & Trust Company, Princeton, *D*, 1949; Trenton Banking Company, Trenton, *L*, 1945.

*New York*—Marine Trust Company, Buffalo, *D*, 1950, *L*, 1950; Bank of New York & Fifth Avenue Bank, *D*, 1945, *L*, 1949; Bankers Trust Company, *D*, 1949, *L*, 1950; Chase National Bank, *D*, 1949, *L*, 1950; City Bank Farmers Trust Company, *D*, 1949, *L*, 1950; Guaranty Trust Company, *D*, 1949, *L*, 1950; The Hanover Bank, *D*, 1946, *L*, 1950; Manufacturers Trust Company, *D*, 1949, *L*, 1950; Marine Midland Trust Company, *D*, 1944; New York Trust Company, *D*, 1950, all of New York City; Lincoln Rochester Trust Company, Rochester, *D*, 1950, *L*, 1950; Security Trust Company, Rochester, *D*, 1945, *L*, 1950; County Trust Company, White Plains, *L*, 1951.

*North Carolina*—The Fidelity Bank, Durham, *D*, 1951; Wachovia Bank & Trust Company, Winston-Salem, *D*, 1941.

*Ohio*—Central Trust Company, Cincinnati, *D*, 1944; Cleveland Trust Company, Cleveland, *D*, 1945; Ohio Citizens Trust Company, Toledo, *D*, 1951.

*Oregon*—First National Bank of Portland, *D*, 1951.

*Pennsylvania*—Fidelity-Philadelphia Trust Company, Philadelphia, *D*, 1940, *L*, 1940; Girard Trust Corn Exchange Bank, Philadelphia, *D*, 1939, *D*, 1950, *L*, 1939; Land Title Bank & Trust Company, Philadelphia, *D*, 1942, *L*, 1947; Pennsylvania Company for Banking and Trusts, Philadelphia, *D*, 1940, *L*, 1944; Provident Trust Company, Philadelphia, *D*, 1940, *L*, 1945; Real Estate Trust Company, Philadelphia, *D*, 1947; Tradesmens National Bank and Trust Company, Philadelphia, *D*, 1945, *L*, 1948; Fidelity Trust Company, Pittsburgh, *D*, 1947, *L*, 1947; Mellon National Bank & Trust Company, Pittsburgh, *L*, 1944; Peoples First National Bank & Trust Company, Pittsburgh, *D*, 1940; Scranton-Lackawanna Trust Company, Scranton, *D*, 1941, *L*, 1946; Miners National Bank, Wilkes-Barre, *D*, 1947, *L*, 1947.

*Texas*—Mercantile National Bank, Dallas, *D*, 1949; Forth Worth National Bank, Forth Worth, *D*, 1948; Frost National Bank, San Antonio, *D*, 1951.

*Virginia*—Lynchburg Trust & Savings Bank, Lynchburg, *D*, 1950; National Bank of Commerce, Norfolk, *D*, 1947; First & Merchants National Bank, Richmond, *D*, 1949; First National Exchange Bank, Roanoke, *D*, 1949.

*Washington*—National Bank of Commerce, Seattle, *D*, 1947.

*Wisconsin*—Marine National Exchange Bank, Milwaukee, *D*, 1944.

In a prudent-man-rule state, such as Massachusetts, Delaware, and North Carolina, the distinction between discretionary and legal funds is pointless in that the two terms mean substantially the same.

trust funds. The letter *D* indicates that a given fund is discretionary; *L*, that it is legal with in the meaning of the terms *discretionary* and *legal* given earlier in the article.

#### NEEDS FOR COMMON TRUST FUNDS

The needs for common trust funds must be considered from two points of view — one, that of the trustee; the other, that of the beneficiary. Yet, it is only fair to say, what is best in the long run for one will be best also for the other.

##### *For Trustee*

Banks and trust companies acting as trustees and as guardians, too, need common trust funds (1) to reduce their operating expenses and (2) to enable them to render better service to more people.

1. *Reduction of expenses.* The administration of a common trust fund enables the bank to reduce operating expenses by administering one large trust instead of numerous small ones. The expenses of bookkeeping, accounting, investing, and other operative activities naturally are reduced by centering activity upon a single account.

This reduction of expenses to the bank as trustee of the fund is, in due time, reflected in reduction of costs of the service to beneficiaries. Some banks with common trust funds charge less for administering trusts invested in common trust fund participation, than for those invested separately.

##### 2. *Improvement in service.*

a. *Diversification.* To the question, "In how small a fund can one obtain first rate diversification?" the answers of investment specialists would vary a great deal. One would say, perhaps, \$25,000; another, \$50,000; and still another, \$100,000. But it is doubtful that any investment specialist would go as low as \$5,000 or even \$10,000. Yet it is a significant fact that of nearly one-half of the trusts under administration by banks and trust companies in this country each yields an annual income of less than \$750. This means that the principal of one-half of the trusts in these banks and trust companies is not over about \$25,000. It is well known that many trusts and guardianships—especially the latter—are less than \$10,000 or even \$5,000, some only \$1,000.

A trustee or guardian simply cannot obtain adequate diversification in a \$10,000 much less a \$5,000 fund. In these small accounts invested separately it can only invest in one or two mortgages or in a small number of shares or bonds. The default of any of these investments would place a large percentage of the whole trust or guardianship in jeopardy, whereas the same \$10,000 or \$5,000 invested in common trust fund participations would give the small account identically the same diversification as the very large account would enjoy. Sound diversification not only helps to stabilize

principal but also to equalize income. If a small trust is invested in one or two mortgages or in a few shares or bonds, the default in one investment would make a major inroad upon the income and might wipe out a large percentage of the principal. If the same investment in a common trust fund defaulted, the income or the principal of the small participating trust scarcely would feel it.

*b. Purchase and sale of investments.* When the trustee of a common trust fund enters the market to purchase or sell investments, it has all the advantages of large-volume business. It obtains all the economies of wholesale purchases and sales. Every advantage it obtains in this way is reflected in improvement of service to beneficiaries.

*c. Acceptance of small accounts.* The expense to trustees of administering very small trusts was almost prohibitive until common trust funds came into use. Not a few banks and trust companies felt that, in justice to their stockholders, they had to limit the size of the trust they would accept, except under extraordinary circumstances. Where such limits were imposed, the very group of beneficiaries that most needed the service of an experienced trustee was the one deprived of it.

But with the coming of the common trust fund, banks were able to accept and to administer small trusts at a profit to themselves with a reasonable charge for the service. From the point of view of the trustee, this has meant the opening of a new field of trust business. At the present time banks with common trust funds are advertising for and soliciting small trusts, knowing that with their common trust fund they can administer them profitably to themselves and economically for the beneficiaries.

#### *For Beneficiaries*

The final test of the need for the common trust fund is its usefulness to beneficiaries. If it meant only reduction of expense and more business for banks and trust companies, its usefulness would be restricted and the device itself might be temporary. But if the common trust fund serves the needs of beneficiaries, its continued existence is assured.

1. *Equalization of income.* One of the benefits of the common trust fund to beneficiaries of small accounts is its aid in equalizing income. This point has been made already in discussing the usefulness of the fund to the trustee in administering trusts and need not be elaborated here.

2. *Stabilizing principal.* No one would claim that a common trust fund completely stabilizes principal. In a period of depression the individual investments in the fund and the fund as a whole would show depreciation in value. By the same token, in a period of inflation, the individual investments and the entire fund would

show appreciation. But, even so, the depreciation in the one case and the appreciation in the other would be less than that in small accounts independently invested.

3. *Periodic payments out of principal.* The annuity type of trust, as it is coming to be known, seems to be growing in popularity with settlors and beneficiaries, as well as trustees. In this type of trust the trustee is directed to pay to or for the beneficiary a stated number of dollars each month or quarter or other period named. It makes no difference whether the payment comes out of income or out of principal or partly out of each. For example, the trustee is directed to pay to the beneficiary \$200 a month. The average income of the trust is only \$100 a month. The other \$100 must come out of principal. How is the trustee to make sure that it will have the \$100 of principal, as well as the \$100 of income, on hand each month? In a trust independently invested, there would be nothing for the trustee to do but keep uninvested the cash necessary to make the monthly payment out of principal. This uninvested cash is, of course, unproductive.

In the same trust, participating in a common trust fund, the trustee would estimate the amount of principal it would need for the payments until the next break-up date of the fund, which at most could not be more than two months, and invest the balance. It already could have invested cash on hand for the first monthly payment. If the fund was opened for additions and withdrawals each month, the trustee need not keep a dollar of the trust uninvested. Thus the common trust fund is ideally adapted to the requirements of the annuity type of trust.

4. *Investment of small amounts.* One of the real problems of every trustee is to keep all of the principal funds of a trust invested and, therefore, productive at all times. Mortgages and bonds will be paid off. Stocks and bonds will be sold. Cash for investment comes in from other sources. As every experienced trustee well knows, it is a practical impossibility to keep principal trust funds invested up to the dollar at all times.

The common trust fund comes nearer solving this problem than any device that has been discovered. The fund is opened for additions and withdrawals at least once a quarter and in most cases once a month. The unit value of these funds ranges from \$1 to \$100, \$10 probably being the favorite unit value at the present time. No case is known of a unit value of over \$100. Although the original unit value of \$1 or \$10 or \$100 goes up or down somewhat as the fund appreciates or depreciates in value, the current unit value changes from quarter to quarter or from month to month within a comparatively small range only. Suppose the original \$10 unit value rose to \$12 or dropped to \$8. This would mean that the trustee could

invest every dollar of principal up to the last \$12 or \$8, as the case might be, at the next monthly or quarterly break-up date. Under no other device known to trust administration can cash principal of trusts be kept invested so closely or so promptly.

#### SUPERVISION OF COMMON TRUST FUNDS

Common trust funds are subject to three kinds of supervision — institutional, governmental, and beneficiary.

##### *Institutional Supervision*

As was brought out in the section on the regulation of common trust funds, every common trust fund must be audited each twelve months by auditors answerable to the board of directors of the bank. This is a special requirement under Regulation F, Section 17, and is in addition to the regular audits of the trust department of the bank or trust company. The regulation also sets forth the information that the report of the audit must contain. A copy of the report must be sent or made available to each person entitled to an accounting in a participating trust.

Furthermore, the regulations impose definite and special duties upon the trust investment committee of the bank or trust company as regards the administration of a common trust fund — such as prior approval of participation, evaluation of assets, determination of sufficient percentage of readily marketable securities. Whereas in the administration of other trusts, the bank is left free to decide which of its duties shall be performed by its employees, its officers, its trust committees, and its board of directors, in the administration of its common trust fund it is directed that certain of its duties shall be performed by its trust investment committee of competent and experienced officers or directors or both.

##### *Governmental Supervision*

The Board of Governors of the Federal Reserve System has promulgated Section 17 of Regulation F for the regulation of common trust funds. If Section 17 is not lived up to in every material respect, in addition to other disciplinary measures that may be imposed, the tax relief may be withdrawn making the fund subject to federal income taxation as an association. This forfeiture of tax relief not only would make the continued operation of the fund a practical impossibility but also it might subject the trustee to surcharge by all the participating trusts for breach of trust in the forfeiture of tax relief.

When the examiners, federal or state, go into the trust department of a bank or trust company that has a common trust fund, they are under a duty to measure the administration of the fund by the requirements of Section 17. Should they find that these requirements are being disregarded, they try to bring the administration of the fund into line with the regulations. If the bank or trust

company is unwilling to come into line, then the appropriate governmental agency invokes its disciplinary power either to make the bank come into line or else close its common trust fund.

It is not at all fanciful to say that common trust funds are under double governmental supervision—the ordinary supervision that applies to all trust accounts and the special supervision that applies to common trust funds alone.

#### *Beneficiary Supervision*

Every trust is open to the inspection of, and in this sense is under the supervision of, every beneficiary of the trust. Every beneficiary of every trust participating in a common trust fund is a beneficiary of the common trust fund and, in this capacity, entitled to inspect the books, accounts, records, investments, and everything else that is pertinent to the common trust fund. However, it should be pointed out that the right of beneficiaries of trusts participating in the common trust fund to inspect the books, accounts, and records of the common trust fund does not open the door for them to inspect the books, records, or accounts of the participating trusts. If this were not true, the confidential element of the trust relationship would be destroyed.

Every beneficiary of every participating trust has the right to inspect the fund. If he or his accredited representative finds or thinks he finds that the fund is not being administered properly, he has the right to complain to the trustee or, if he desires, to the court. If it turns out to be a fact that the fund is not being administered properly in any material respect, the correction or the relief initiated by a single complaining beneficiary enures to the protection or benefit of every beneficiary in every participating trust.

If any bank or trust company ever should be disposed to be negligent in the administration of any of its accounts, it could least afford to be negligent in the administration of its common trust fund because the eye of every beneficiary of every participating trust would be upon its administration and any dissatisfied beneficiary would have the right to call upon the trustee to account for its administration of the fund.

#### COURT ACCOUNTING FOR COMMON TRUST FUNDS

Attention has been called recently to what may turn out to be a serious defect in much of the state legislation authorizing the establishment and maintenance of common trust funds by state banks and trust companies,<sup>47</sup> i.e., the failure of nearly one-half of the state enabling acts to have any provision for the trustee of a common trust fund to make periodic accountings to the court and, upon hearing and approval of the account, obtain clearance of its

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<sup>47</sup> Note, 64 HARV. L. REV. No. 5 (1951); TRUSTS AND ESTATES 504 (August 1951).



administration of the fund up to the period of the accounting. The New York court accounting act for common trust funds was held unconstitutional because of the method of notifying beneficiaries.<sup>48</sup>

It would seem to be highly beneficial for the trustee to be able to make periodic accountings to the court and obtain clearance for its administration up to the time of the accounting. If such intermediate court accounting acts are needed for individual trusts—and they have proved to be much needed—they must be needed all the more for common trust funds. The beneficiaries of participating trusts are numbered by the hundreds or thousands. The fund runs on from year to year, possibly from generation to generation, with ever changing participating trusts each with its own beneficiaries. It does not seem quite fair to the trustee—or to the beneficiaries—for the common trust fund to run on and on without the trustee's ever having its day in court to account for its administration of the fund up to the time of accounting.

The drafting of a practical, workable, inexpensive intermediate court accounting act for common trust funds would seem to be a challenging and rewarding task for lawyers who are interested in trust administration whether as attorney for beneficiaries or for banks and trust companies as trustees of common trust funds.

#### PROVISION IN TRUST INSTRUMENT FOR INVESTMENT IN COMMON TRUST FUND

If the draftsman of a will or trust agreement and his client (after the common trust fund device has been explained to him) decide to name a bank or trust company his trustee and desire to have the trustee free to invest the funds of his trust in its common trust fund, the instrument should contain a provision authorizing the trustee to invest the funds of the trust in participations in its common trust fund. It need be no more than authority so to invest. Direction to do so, as explained already, would be ineffective, since the common trust fund must be under the exclusive control of the bank with power to include or exclude participation as it deemed best.

Authority might be given in the instrument although the bank or trust company did not have a common trust fund at the time nor have any intention of establishing one. It might change its mind and establish one sometime later while the trust still was under its administration.

The provision need be only a sentence authorizing the trustee or its successor to invest in participation in common trust funds under its administration for the exclusive use of its estates, trusts,

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<sup>48</sup> *Mullane v. Central Hanover Bank & Trust Co.*, 339 U. S. 306 (1950), *reversing In re Central Hanover Bank & Trust Co.*, 299 N. Y. 697, 87 N.E. 2d 73 (1949), *which affirmed* 275 App. Div. 769, 87 N. Y. S. 2d 907 (1949)

and guardianships. The term *common trust fund* would be given its technical meaning under the statutes and regulations.

Judging by the way common trust fund enabling acts and common trust funds themselves have grown in recent years, as shown by the list earlier in this article, one may, with reasonable assurance, regard common trust funds now as one of the accepted devices for the administration of trusts and guardianships — particularly of small accounts — by banks and trust companies.